THE ECONOMIC SITUATION

Bruce Yandle
Dean Emeritus,
College of Business & Behavioral Science, Clemson University
Director, Strom Thurmond Institute Economic Outlook Project
yandle@clemson.edu

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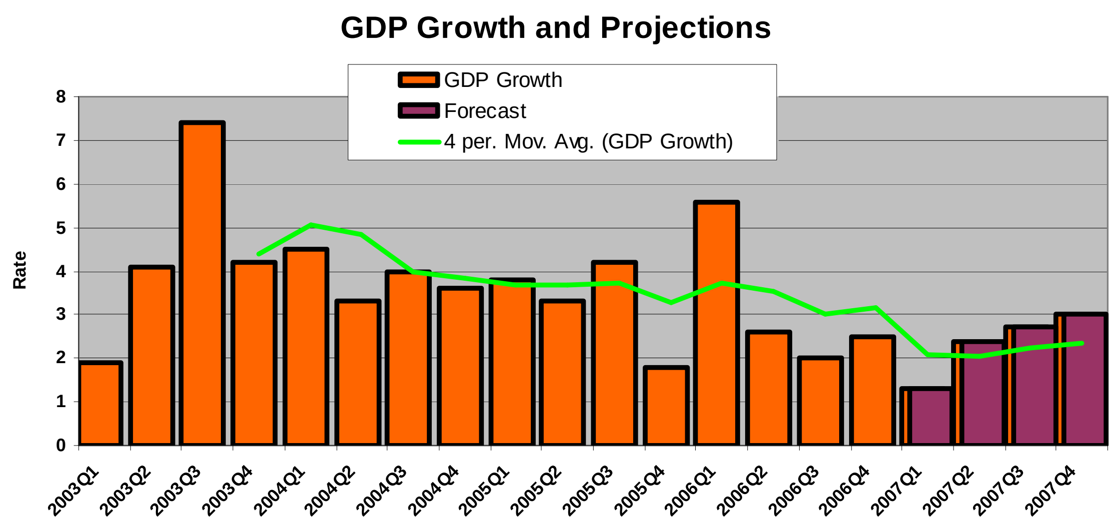
- A slow economy now. Get prepared for a better second half.
- Money calls the tune, but the taxman takes his toll.
- If flat taxes are so great, why don't we have them?
- Want more income? Get more knowledge.
- Freedom and income rise together.
- Are oil prices really rising?
- Report card time.
- Miracles are occurring all around, but not many people are celebrating.

Living the good life in a throttled economy.

It was enough to give a bad case of GDP blues. The 1.3% initial estimate for 1Q2007 real GDP growth was the slowest quarterly rate in four years! But worse than that, as the chart here shows, the economy has been sputtering for almost four years. (The 4-quarter moving average shown in the chart slopes downhill.)

It's not hard to make a long list of negative factors that might explain this weak performance. A war that destroys human and physical capital. Oil price increases that drive up transportation and production costs. Delays and other costs associated with post-911 security activities. A long series of Fed initiated interest rate increases for the purpose of keeping a lid on growth. A sharp decline in residential construction. Federal spending that places the economy in permanent trade deficit. Quite a list!

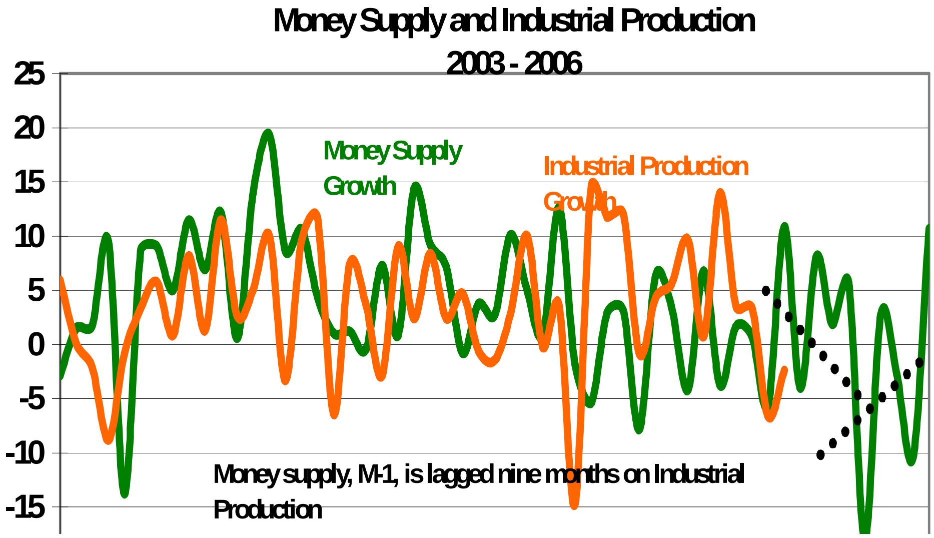
But, with all that, the prospects for a happier last half are still in the cards. How can that be?



The sharp reduction in first quarter residential construction took a full percentage point away from the GDP growth estimate, and that drag is diminishing. Other revisions in preliminary estimates used to build the estimate are likely to be positive.

Money supply growth calls for a better day.

The relationship between growth in the money supply and later growth in industrial production regularly celebrated on these pages is still intact. And lagged money supply growth is predicting a better second half. The next two next charts tell the tale. The first chart was presented in the Situation Report in December 2006. At the time, it showed trend lines marking 2007’s industrial outlook. The second chart shows how industrial production growth has followed the money. Again, the forecast for 2007’s last half looks good. Barring powerful events that could disrupt economic growth—a run-up in oil prices, war in Iran, to name two—we should expect to see better times ahead.


Money Supply and Industrial Production
2003 - 2006
Money Supply Growth
Industrial Production Growth
Money supply, M-1, is lagged nine months on Industrial Production
25
20
15
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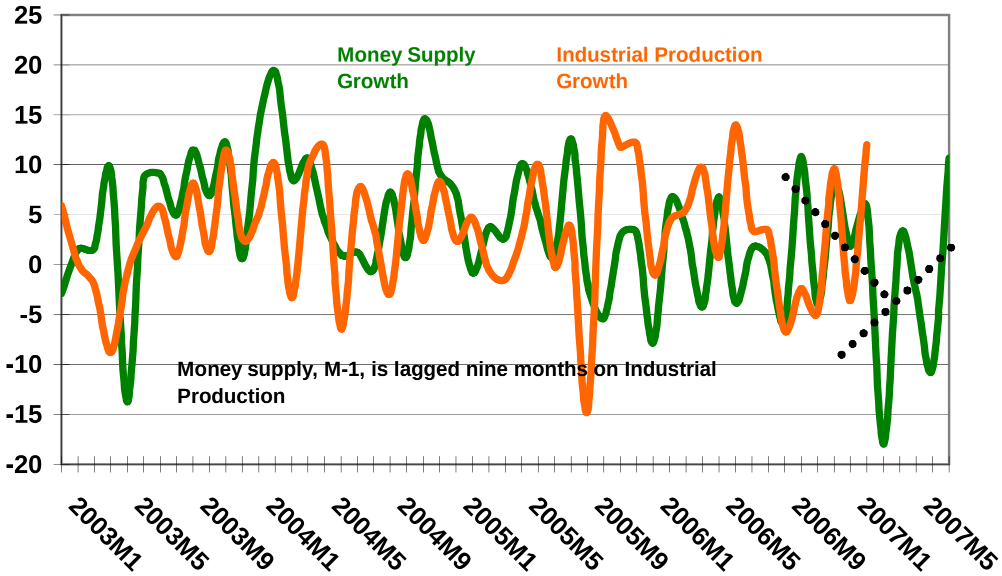
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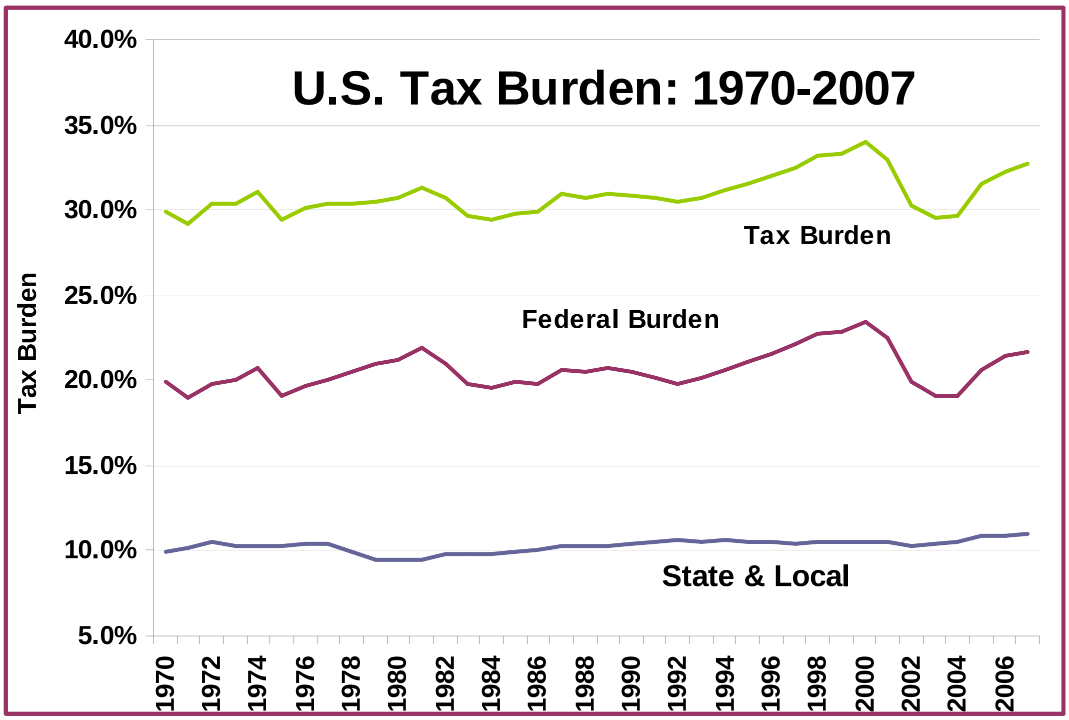
2003M5
2003M9
2004M1
2004M5
2004M9
2005M1
2005M5
2005M9
2006M1
2006M5
2006M9
2007M1
2007M5

The Taxman takes a larger toll.

Though running rough, the old Bread Machine is producing more income, a healthier population, and a country still seen as a city on a hill for multitudes who seek a better life. But while we celebrate the power of the economic engine, we must also pause and recognize the power of the taxman. The taxman may talk about tax cuts and all that but the toll is on the rise. Once again the tax burden, which is the percent of income accounted for by taxes, is well above 30%.

As shown in Tax Foundation data, the state and local average tax burden has hardly budged. But after peaking in 2000 and falling for a few years, the federal tax burden is again on the fly.



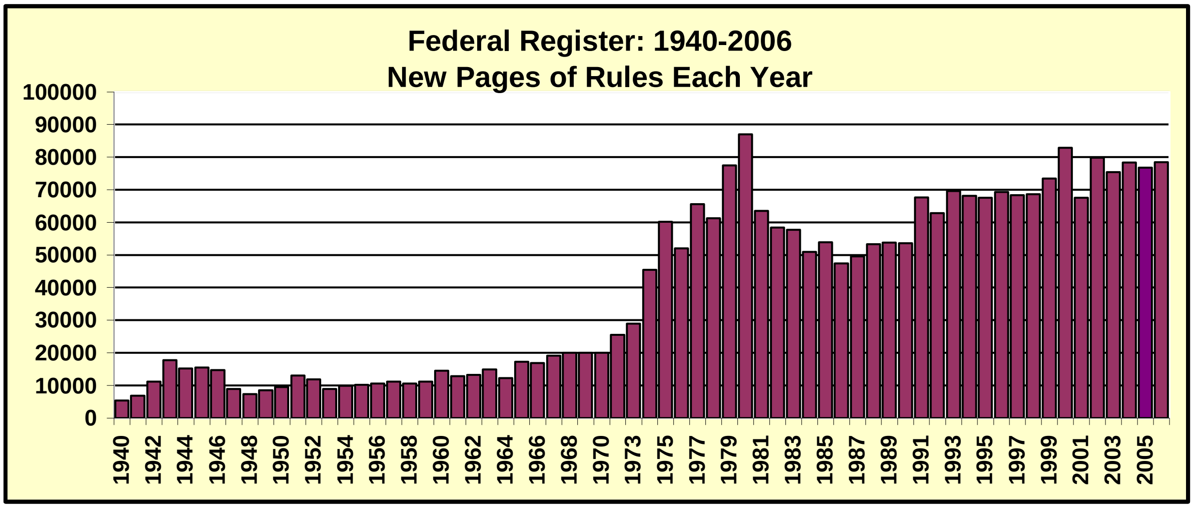
By the way, a similar pattern is seen for South Carolina's combined state and local tax burden. In 2002 the burden rested at 9.9% of the income of the average taxpayer. The burden has risen every year since 2002 and now rests at 10.7%

As the Beatles put it in their 1966 song *Taxman*:

If you drive a car, I'll tax the street,
If you try to sit, I'll tax your seat.
If you get too cold, I'll tax the heat,
If you take a walk, I'll tax your feet

That wonderful average American now has a heavier tax burden and, as shown in the next chart, a heavier regulatory burden.

In case you may have wondered, the age of big government is not over. Pass the word.



What ever happened to flat taxes?

While thinking about the taxman, this may be a good time to check on flat taxes, an idea first proposed 25 years ago by Alvin Rabuska and Robert Hall. Revisiting the topic in the Winter issue of *Hoover Digest*, Alvin tells how efforts to transform the U.S. tax system by way of a flat tax met with no success, this in spite of the efforts of Ronald Reagan and Steve Forbes. But while the U.S. has remained committed to higher taxation of productive and creative citizens, another group of countries has embraced the flat tax concept, and they are doing well. Revenues are up and some dimensions of life are improving.

Now get this. It turns out that Estonia, Georgia, Kuwait, Latvia, Lithuania, Macedonia, Serbia, Slovakia, Ukraine and now Russia have moved to flat taxes. (Russia's is 13%.) Mexico is considering a move. The flat tax rates now in place around the world range from 10% to 19%. (A quick glance at the federal tax burden chart tells how this compares to the U.S. tax burden, which of course is not the same thing as the marginal or average tax rate. We are at 21.7% and holding.)

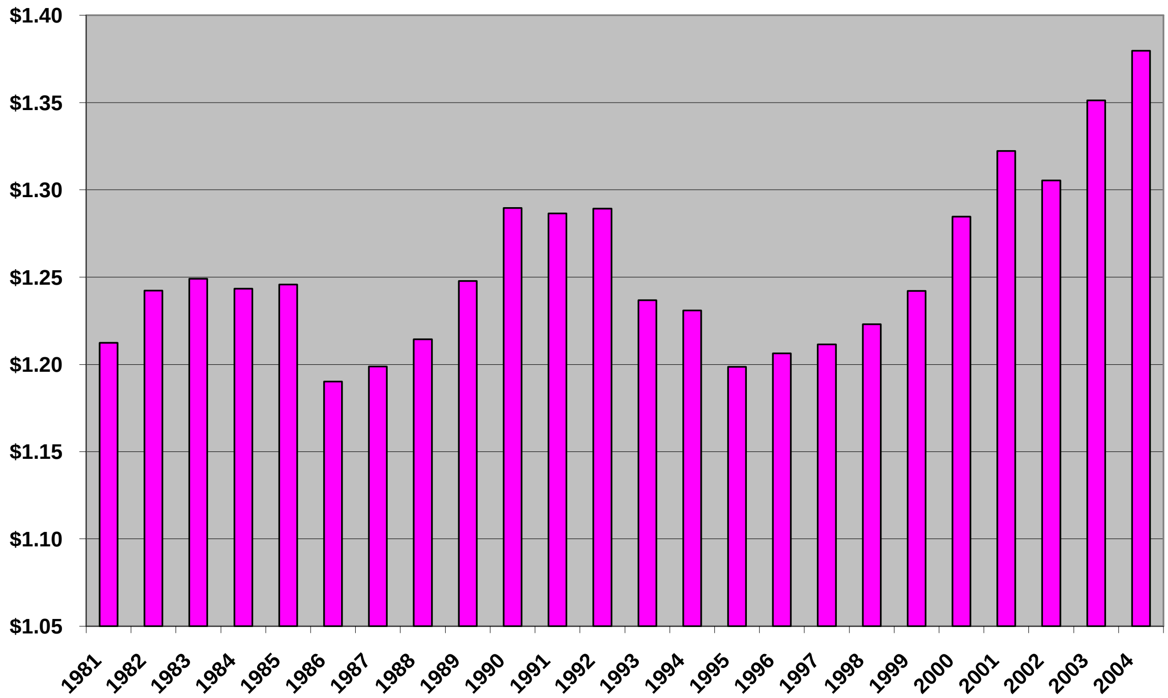
If flat taxes are so great, why don't we vote them in?

One answer to the question is shown in the next chart. South Carolina and lots of other states get more back from the feds than is shipped to Washington. As John C. Calhoun reminds us, there are taxpayers and tax receivers, and they usually are not the same folks. And then there are tax brokers, the politicians who earn a cut from the process.

By the way, the District of Columbia gets more than $6.00 for each dollar sent to the feds. And they say they are hurting because of taxation without representation.

Just wait till representation arrives!

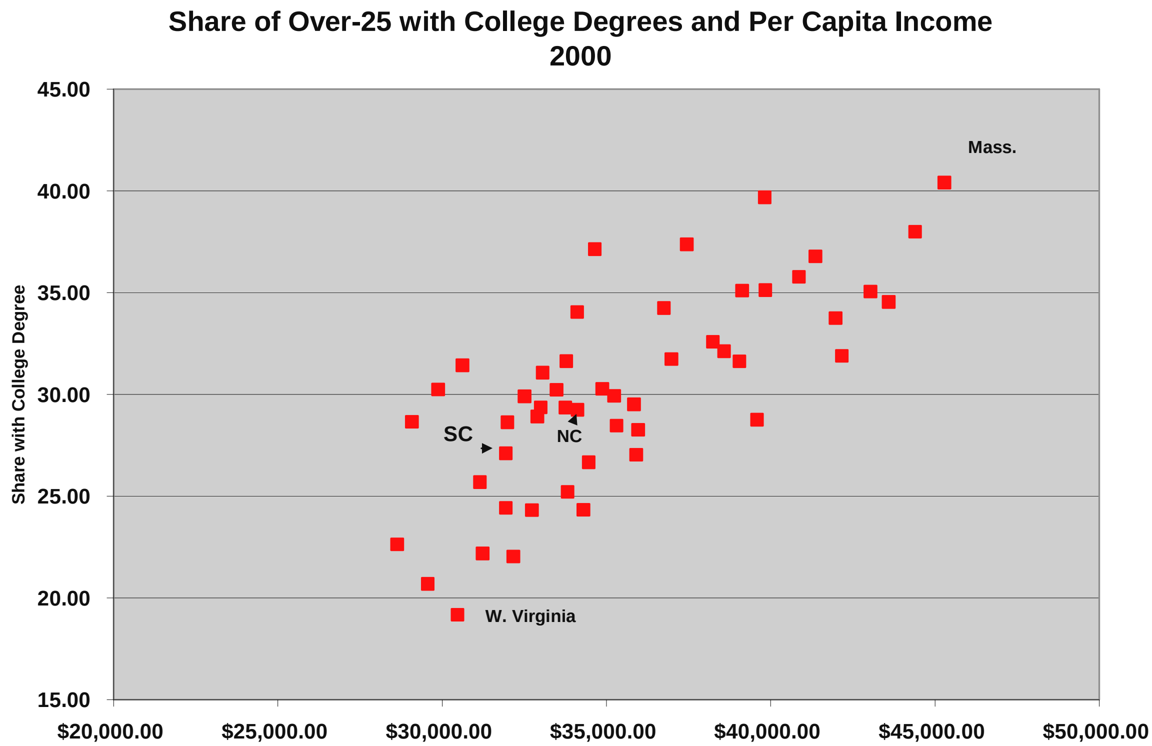
SC: Dollars Received from Washington for Each Dollar Sent



To get on board, get a college degree.

It may seem unnecessary to report the obvious, but saying that educated communities are also high earning communities is not quite the same thing as looking at the data. The next chart shows a mapping of state educational attainment and state per capita income. The mapping is tight. I have marked four states, two that form boundaries, upper and lower, and two interior states, South Carolina and North Carolina.

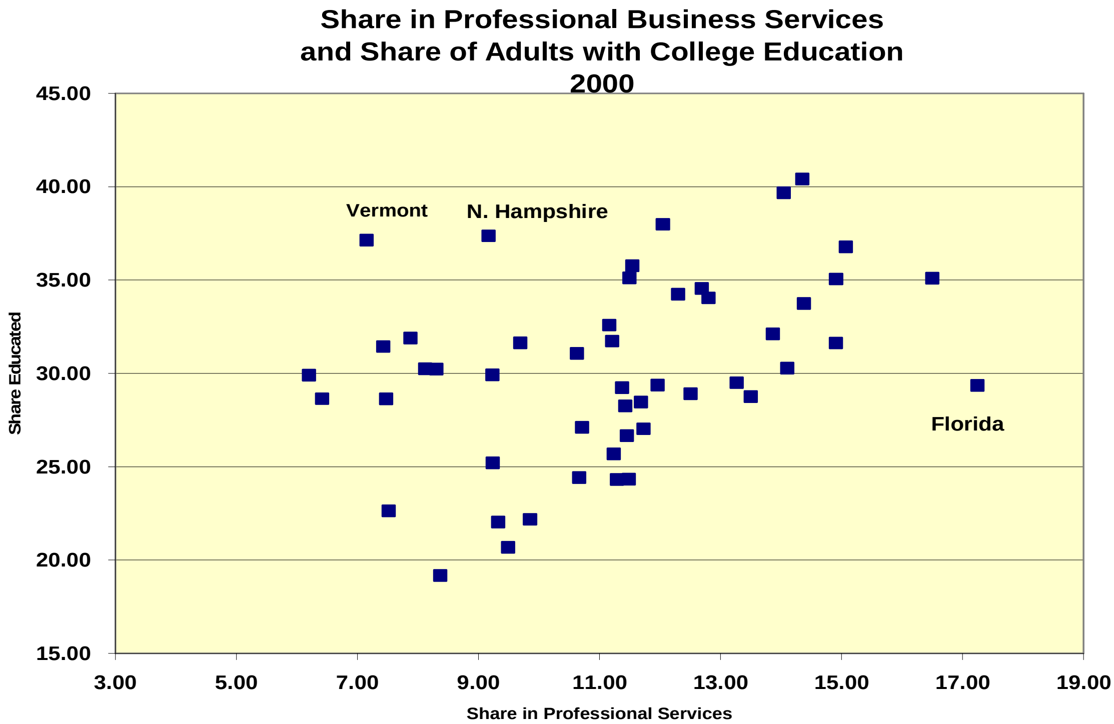
The lesson here is obvious. Investment in human capital—better known as education—produces wealth.



More on the knowledge economy.

Knowledge economy workers are employed in a sector called Professional and Business Services. But as might be expected, a college degree is an important credential for those called knowledge workers. It is also the case that state per capita income is closely correlated with the share of workers employed in the knowledge sector.

This next chart shows how state data for the share of adults with college degrees maps into the share of workers employed in Professional and Business Services. I have marked three outlier states. Vermont and New Hampshire have less than their expected share of knowledge workers given the education level. Florida has a larger knowledge economy than educational levels predicts.



With educational attainment a prerequisite for employment in the burgeoning services economy, we should expect to see higher salaries in the services sectors. The next chart gives a comparison of hourly wage rates for several major U.S. sectors. The services sector makes a good showing. Based just on the raw data here, one can forecast rising per capital income for communities now making the transition to services.

Manufacturing & Other Hourly Wages
December 2005

Manufacturing	$16.82
Utilities	27.03
Information	22.79
Construction	19.72
Wholesale Trade	18.43
Professional Services	18.37
Financial Activities	18.27
Education/Health Svcs.	17.01
Trucking/Warehousing	16.97
Private Service Producing	15.98

Bureau of Labor Statistics. Reported in Alan reynolds.
Income and Wealth. 2006, 191

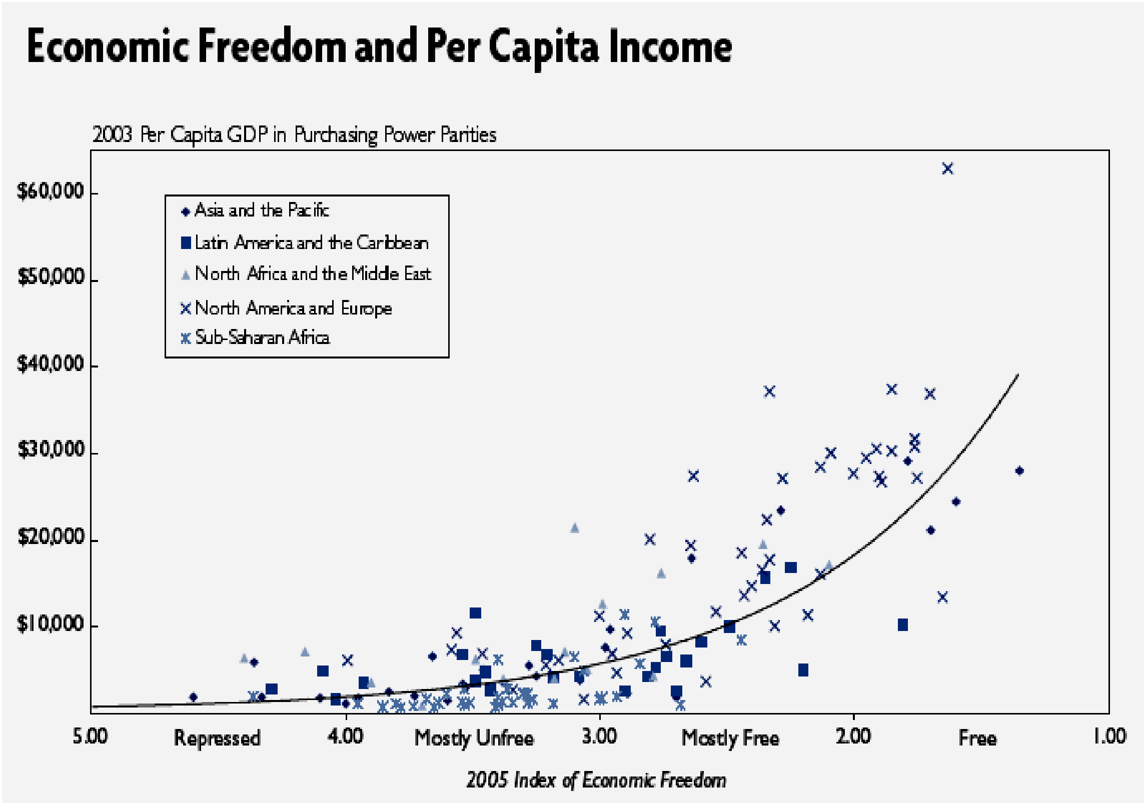
Let freedom ring!

For fans of better schools, improved health care, cleaner air and water, and safe communities, economic freedom is a good thing.

Why? Countries with higher levels of economic freedom generate higher levels of income. And higher incomes generate improved wellbeing, as well as lots of other stuff.

The chart for countries around the world is shown next.

It is a rather compelling story.

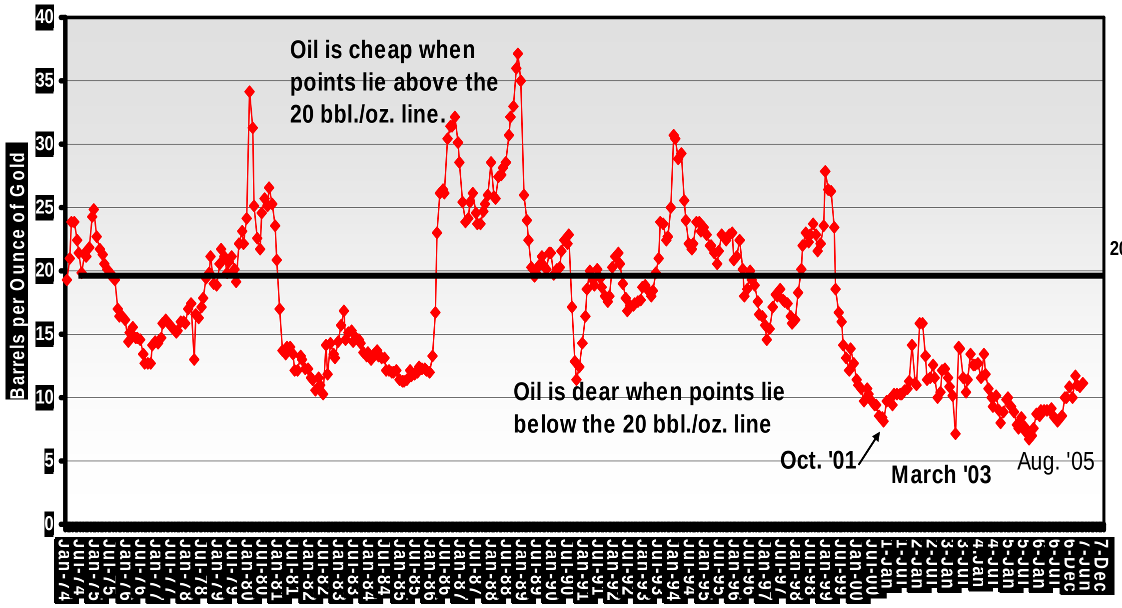


Oil at $45 a barrel! Was it a typo?

I received an email message from a reader asking me about my end of 2007 forecast for oil prices. My forecast calls for $45 a barrel oil. The question he posed: Is this a typo? I fired back, “No, the forecast is based on hard data.” The next chart is familiar to Situation Report readers. For the sake of new readers, the chart shows an old established relationship between gold and oil. Historically, Arab traders exchanged 20 barrels of oil for an ounce of gold, except when at war are caught up in other political intrigues, such as now.

I have updated the chart and extended the horizontal axis so that a forecast can be made. A few strategic dates are also marked. Entry into Afghanistan. Start of Iraq invasion. Katrina. Believe it or not, the price of oil is now falling…, in terms of gold! The trend points toward the 20 barrel line, with some distance to go. When a straight edge is placed on the data points, the resulting trend forecast puts the price at $45 a barrel in December.

Let’s hope war and the politics of confiscation let up so that it happens.



But does higher income bring happiness?

The rapid growth in income and wealth in the developed world has brought with it a new scholarly pursuit called happiness studies. Happiness scholars seek to identify what explains the level of self-reported happiness across countries. Related to this are other interesting questions: Do higher income levels correlate with happiness? (Can you buy happiness?) And are increased levels of economic freedom associated with higher levels of self-reported happiness?

In a survey of the topic for Cato Institute, Will Wilkinson reports that self report happiness in many studies rises with income, but at a diminishing rate. The relationship between self reported happiness by country and economic freedom is even more pronounced and less inclined to diminish with more freedom.

Of course, the studies always have outliers that make the story interesting. In a ranking of countries, the top 10 are Puerto Rico, Mexico, Denmark, Ireland, Iceland, Switzerland, N. Ireland, Netherlands, Canada and Austria. Oh yes, the United States is 14th in the list. In studies that include as many as 200 countries, the United States always ranks in the 90th percentile on the happiness meter, and almost always lies above most European countries. Related statistical work shows that U.S. reported happiness is unaffected by what happens across time to income distribution. Even when the rich are getting richer, the reported level of happiness for a population cross section shows happiness at lower income levels is unaffected.

What is not reported in the studies, and cannot be, are the small things in life that are perhaps the real gems of happiness. These are the small miracles like a good cup of coffee in the morning, an unexpected telephone call from a friend not heard from for a while, or a few hours alone with a good book.

Mid-term report card.

It is now six months since I published my December 2007 forecast for some important economic indicators. In case, this did not get placed on the refrigerator door, I provide a copy for the record.

	12/06 Forecast	*Actual 12/06*	*12/07*
GDP	3.8%	3.2%	2.7%
Inflation	2.7%	2.6%	2.5%
30-yr. Mortgage	6.80%	5.82%	6.0%
Unemploy Rate	4.4%	4.5%	4.0%
Prime	7.70%	8.25%	7.75%
Dow	11,500	12,460	13,200
Employ.	200M	150M	175M
Oil	$ 67.00	$ 58.00	$45.00
Gold	$ 510.00	$ 604.00	$600.00

At this point, some of the estimates look pretty good. Most forecasters are now calling for 2.7% real GDP growth. Inflation is running about 2.5%, and on May 10, 2007, as this is written the 30-year fixed rate mortgage is fetching 5.77%. Unemployment is holding steady at 4.5%, but we have six more months to go! The prime hasn't budged, and the prospects for 7.75% prime are not real good.

The Dow has now crossed the 13,200 level, and will likely exceed that number in December. But, on the other hand….? Employment gains are hitting close to 175,000 per month. But oil? And gold? Those numbers are out of sight.

Still, this is my story, and I'm sticking with it. It is a one shot benchmark to be used in following markets. As mentioned recently to a friend, the value of a forecast is that it provides a basis for testing competing ideas and for generating a useful discussion about real decisions. (We forecasters always say something like this when the numbers don't look good!)

At the end, some very good news.

Regular readers know that I am fond of referring to the magnificent capitalistic system as the Great American Bread Machine. The habit of doing so developed years ago, long before other countries of the world had embraced capitalism, and, I should add, long before U.S. political forces eroded key parts of the nation's great capitalism foundation. For me and many others, capitalism provided a path to a better life. Now, of course, the Great Bread Machine embraces countries and people worldwide. And the progress report card looks powerfully good.

Drawing on data from the World Bank, *The Economist* reports that the number of people living on less than $1 a day fell in 2004 to 986 million or to 18.4% of the developing world population. The number is staggering, but in 1990, the share was 29%!

The most striking improvement has occurred in China. In 1990, some 374 million people or 33% of the population were estimated to live on less than $1 a day. In 2004, the figure was 128 million or 9.9%. History offers nothing to compare with this. And now prospering China is the fastest growing market for U.S. goods.

The Bread Machine enables ordinary people to engage in actions that yield miracle outcomes.

When pondering these numbers, one might wonder who are the keepers of the $1.00 data? The amount, $1.00 per day, turns out to be an important poverty threshold identified by World Bank analysts. Based on the amount needed to provide 2,250 calories a day in rural India, a similar poverty threshold was found by World Bank analysts in some 33 other developing countries.

But how, one might ask, can people survive on just $1 a day or less? The answer, of course, relates to subsistence farming. For example, Mercatus Center Senior Scholar Karol Boudreaux reports that some 38% of Namibia's population has no money income at all. In a country without well developed property rights, the squatters live off the land and trade some of their produce for other necessities.

If you wish to know more about Namibia and how crude property rights developing there are forming a market economy, you will want to read a recent report by Karol Boudreaux. The report is found at www.enterprise-africa.org.

The Bread Machine is a miracle. Why aren't more people celebrating?

A power story.

In remarks made recently at a Cato Institute gathering, FedEx CEO Frederick W. Smith talked about world trade and his firm. He pointed out that the U.S. is a leader in the production of high valued, low weight, high technology good. This goods category now accounts for 15% of GDP. (It was one percent in 1970.) He went on to explain that shipments by container vessels now account for 98% of the tonnage of all movement in international trade.

But here's the kicker. Air shipments account for just 1.5% to 2% of all tonnage in international trade, but 40% of the value of international trade.

The U.S. lags in producing low value commodities, and will continue to do so. We lead in producing high value, low weight products, and the future for growth is bright indeed.

Meanwhile, incomes are rising.